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UNCLAS SECTION 01 OF 05 TAIPEI 003051

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TAGS: EINV EFIN ECON PINR TW

SUBJECT: Taiwan Economy: Sunny With Polychrome Clouds

Ref: (A) Taipei 2695

- (B) Taipei 2574
- (C) Taipei 1549
- (D) 05 Taipei 4647

SUMMARY

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¶1. (SBU) Summary: Local think tanks forecast rising exports will keep Taiwan's economic growth rate at around 4% in 2006 and 2007 and bring Taiwan's unemployment rate below the current 3.9%. Private consumption and investment (75% of GDP) are recovering from high card debt and inventories, and net capital outflows mitigate excess liquidity in Taiwan. This sunny forecast contrasts sharply with media reports and widespread perceptions of gloomy economic prospects. End summary.

Taiwan Media Reports Paint Bleak Picture

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¶2. (SBU) The Taiwan media seems to thrive on doom and gloom stories of unemployment, suicide, crime, and corruption. Articles on economic issues commonly include data presented to make Taiwan's economic situation appear bleak. Recent articles, even in economic-focus newspapers, have reported that foreign investment is continually declining, that Taiwan families are worse off than five years ago, and that Taiwan's level of unemployment and poverty threaten its social stability, etc. Most economists looking at Taiwan's economy, along with its crowded restaurants, stores, and

streets would not draw these conclusions.

#### Forecasts by Four Major Think Tanks

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**¶3.** (U) During July and August four major Taiwan think tanks published updated economic forecasts for 2006, and two released 2007 forecasts. The Directorate General of Budget, Accounting and Statistics (DGBAS), Taiwan's official statistics agency, predicted on August 18 that economic growth will increase from 4% in 2005 to 4.3% in 2006 and will remain above 4% in 2007. The independent think tanks Chunghua Institution for Economic Research (CIER), Taiwan Institute of Economic Research (TIER), and Academia Sinica produced similar estimates with economic growth for 2006 and 2007 projected at around 4%.

#### Exports Drive Economic Growth

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**¶4.** (U) Taiwan Customs data show y-o-y export growth increased from 8.8% in 2005 to 14% in the first seven months of 2006, with the monthly growth rate accelerating from 10% in May to 16.5% in June and 21% in July. Growth in export orders in Q2, the basis for actual shipments in Q3, increased to 21.6% from 21.2% in Q1 of 2006, both higher than 15.1% in Q2 of 2005. The four Taiwan think tanks believe that export expansion will continue to propel Taiwan's economic growth in 2006 and 2007, despite the dampening effects on foreign demand of higher interest rates and higher energy costs. Taiwan relies heavily on export-led growth from exports to China (including Hong Kong), which takes more of Taiwan's exports than the United States, Japan, and the EU combined. This provides some insulation to Taiwan from the widely anticipated slowing demand in developed markets.

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#### Relocation to China Boosts Taiwan's Economy

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**¶5.** (U) Taiwan's political parties, media and economic actors have been endlessly debating whether or not industrial relocation to China will "hollow out" the economy. However, statistics clearly show that relocation to China is a major contributor to Taiwan's export expansion and has enabled firms to increase sales to developed markets. Taiwan production bases in China import inputs from Taiwan, including machinery, equipment, components, and semi-finished goods. Taiwan's exports to China (including Hong Kong) have grown faster than its exports to other markets, increasing as a percent of total exports from below 20% prior to 2000 to nearly 40% in July 2006.

... Trade Surplus,

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**¶6.** (U) According to Taiwan Customs data, the trade surplus with China in 2005 reached US\$50 billion; double its 2001 level of US\$24 billion, and grew another 17%, to US\$34.7 billion, in the first seven months of 2006. Since the year 2000, Taiwan's trade surplus with China has totaled US\$221.7 billion, far more than its global trade surplus of US\$7.4 billion over the same period. Trade with China is the main source of Taiwan's huge and growing trade surpluses.

... Increased ForEx Reserves,

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**¶7.** (U) Industrial relocation requires investments to flow from Taiwan to China, but also creates inflows of capital in the form of trade surpluses. Trade surpluses have increased Taiwan's forex reserves and money supply (liquidity). Taiwan's trade surplus with China since 2000 dwarfs Taiwan's cumulative direct investment in China (US\$51 billion according to official statistics or US\$70-100 billion, according to private estimates). The US\$221.7 billion cumulative trade surplus with China since 2000 has contributed to boosting Taiwan's forex reserves by US\$153.6 billion, to US\$260.4 billion, over the same period.

... And Increased Employment

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**¶18.** (U) Taiwan's unemployment rate declined to below 4% in November of 2005 from a historical high of 5.3% in August 2001. A recent commentary in the Economic Daily News (EDN) explained that exports to China over the past six year have created 810,000 jobs, far more than the number of layoffs due to industrial relocation. The unemployment rate fell to 3.78% in April, and has remained below 4% since then.

Economic Evolution Towards Increased Value-Added

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**¶19.** (U) Taiwan firms are still expanding high technology manufacturing in Taiwan. The excess inventory that contributed to reduced private investment in H2 of 2005 has been largely eliminated. Imports of capital goods (for production) grew y-o-y at a rate of 6.3% in June and 15% in July. New semiconductor and flat panel projects have turned Taiwan into the world's largest buyer of

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Applied Materials' high tech production equipment; outpacing Japan and South Korea.

Increased Foreign Investment

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**¶10.** (U) Approved foreign investment (FDI) in Taiwan in the first seven months of 2006 totaled US\$8.3 billion, nearly five times the level in 2005, and approved FDI in electronic industries surged to US\$4.4 billion, 16 times the level a year ago. Taiwan's accomplishments in financial consolidation and strong consumer purchasing power attract foreign investment into its financial and commercial sectors. Approved FDI in Taiwan's financial sector in the first seven months of this year totaled US\$2.2 billion, nine times the same period of 2005. Meanwhile, approved FDI in wholesale/retail firms surged 63% to US\$454 million. Financial institutions and wholesale/retail firms contributed 40% of GDP in H1 of 2006, up from 33% ten years ago. Despite a 0.2% decline in domestic private investment, approved FDI increased in 2005 by 7%.

**¶11.** (U) Foreign investment in Taiwan financial institutions in the first few months of 2006 includes:

--GE Consumer Finance (Cosmos Bank) NT\$2.75 billion;  
--Newbridge Asia (Taishin Financial Holdings) NT\$27 billion;  
--Normura Securities (Taishin Financial Holdings) NT\$4 billion;  
--AIG (Central (Non-life) Insurance with NT\$6 billion;  
--Citicorp (Fubon, partially withdrawn);  
--Prudential Life (E. Sun Bank);  
--New York Life (Bank of Overseas Chinese);  
--Temasek Holding (E. Sun Financial Holdings);  
--BNP Paribas (Cooperative Bank of Taiwan);  
--Shinsei Bank (Jihsun International Commercial Bank);  
--Newbridge (Kuo Hua Life);

Consumption Recovers from Card Debt

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**¶11.** (U) A sharp increase in delinquent credit/cash card debt earlier this year prompted banks to temporarily tighten lending to consumers, dampening private consumption growth to 1.4% in Q2 of 2006 from 3% a year earlier (refs B&C). However, this problem has been effectively addressed through debt rescheduling and debt write-offs. Several private banks recently again launched credit card promotion campaigns. DGBAS forecasts private consumption will grow 2.2% in Q4 this year and 2.9% in 2007 while CIER predicts 2007 growth will exceed 3%. Both predictions are higher than the average annual growth of 2.5% over the past four years.

Capital Outflow Lessens Liquidity

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**¶12.** (U) Like Japan, Taiwan has seen excess liquidity build up as a result of export sales to and through production bases in China, and to a lesser extend from export sales to developed markets. Taiwan's Central Bank of China (CBC) has tried to absorb the excess liquidity by issuing negotiable certificates of deposits (NCD). Outstanding NCD and savings deposits re-deposited by CBC total NT\$5.1 trillion (US\$156 billion), an amount equivalent to the total of currency in circulation and deposit money. CBC recently began permitting secured NT dollar (NTD) bank loans to be designated as foreign

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direct investment (FDI) in Taiwan as an additional way to absorb excess liquidity (ref A).

#### Excess Liquidity Leads to Capital Outflow

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**¶13.** (U) Excess liquidity depresses interest rates and widens the difference between interest rates in Taiwan and the United States. Higher U.S. interest rates along with Taiwan tax exemptions for overseas earnings encourage capital outflow. Although CBC has raised interest rates eight times over the past two years, Taiwan rates remain 2.9 percentage points lower than U.S. rates. Higher interest rates abroad encourage firms to invest overseas. Net outbound investment in H1 of 2006 totaled US\$15 billion, mitigating Taiwan's excess liquidity problem.

#### Other Urban Legends

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**¶14.** (U) Some of the other "common knowledge" about Taiwan's economic situation that is less than true includes:

-- Reports of a 30% drop in auto sales: While overall auto sales in H1 fell by 4.6%, sales of luxury cars, motorscooters and motorcycles increased; Mercedes Benz and Lexus sales increased by over 20% during this period. Overall passenger car sales through the end of July were up 2.1% y-o-y.

-- Declining real estate prices: Residential house prices in Q2 this year registered a 12th consecutive quarterly rise according to an index compiled by industry and academics. In Taichung, the average price of high-rise housing units has increased by 47% since 2003. Overall housing prices increased by 20-30% in this period.

-- Declining consumption: Y-o-Y wholesale and retail sales growth increased from 5% in Q1 to 6.9% in April, 7.8% in May, and 9.2% in June. Taiwan hotels reported 4.5% revenue growth in H1. The Sogo department store's reported decline in sales this year follows a consumer shift towards other types of retailers, as happened in Japan.

-- Growing income gap: In fact, the income ratio of the wealthiest quintile to the poorest quintile was lower in 2004 and 2005 than it was in 2002 and 2003. Taiwan's income disparity is still one of the lowest in the world, second in Asia to Japan.

-- Declining disposable income: According to DGBAS statistics, disposable income has gone up every year since 2001. Disposable income in 2005 exceeded the high set in 2000 on both a household and per capita basis.

-- Domestic investment less than outbound investment: Much of recent FDI has been channeled into high-tech manufacturing and financial sector consolidation, while outbound FDI is mainly low tech manufacturing in search of lower production costs.

-- Business criticism: While there are widespread complaints about current economic policies there are few practical alternatives suggested. Taiwan's Commercial Times printed two commentaries by "business leaders" in the past week criticizing current economic policies, but failed to note that the authors had been indicted in Taiwan on financial crimes and subsequently fled to China. The

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commentaries lauded the superior PRC "understanding" of the needs of Taiwan businesses, without mention of the vastly different political contexts.

Clouds are Mainly Political

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¶15. (SBU) Ongoing corruption scandals, campaigns to unseat the President, the Doha Round suspension, and failed initiatives on cross-Straight relations have deepened the pessimism of many local pundits. A Legislator recently told AIT that hopes for a cross-Straight agreement on banking supervision were dashed by the political chill caused by Chad's switching diplomatic recognition, and that pending regional and bilateral trade agreements were bad news for Taiwan's economy since Taiwan was excluded from these arrangements. She warned Taiwan may see major firms de-listing from the Taiwan stock exchange. An AmCham executive recently responded to the positive economic statistics by noting that Taiwan's economy could and should be doing much better. The think tank predictions of good economic prospects conflict sharply with the widespread pessimism in both public and business perceptions. The economic numbers look good. The clouds on the horizon are tinged with shades of the green, blue, orange, purple (tax reform) and red (dump Chen) of Taiwan political factions.

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